Small Business Regulatory Advisory Council

How to Categorize Impact on Small Business
DRAFT Guidance for State Agencies

The Council's first step in a threshold analysis consists of identifying the industry, governmental and nonprofit sectors they intend to regulate. In the past, many agencies used the Standard Industrial Classification (SIC) codes to categorize regulated businesses on an industry-by industry basis. In 1999, the SIC system was replaced by the North American Industry Classification System (NAICS) which breaks down industry sectors in much greater detail.

The FL RAC defines small businesses as those companies with 500 or fewer employees, the same measure generally used by the US Small Business Administration. In Florida, that includes 1.9 million companies.

Definition of "significant" and "substantial"
The Council's second step in a threshold analysis is to determine whether there is a significant economic impact on a substantial number of small entities. Although HB 7109 does not define "adverse," "significant," or "substantial," the similar federal legislation utilizes the following guidelines.

What is "significant" or "substantial" will vary depending on the problem that needs to be addressed, the rule's requirements, and the preliminary assessment of the rule's impact.

The Council is in the best position to gauge the small entity impacts of its regulations.

Significance should not be viewed in absolute terms, but should be seen as relative to the size of the business, the size of the competitor's business, and the impact the regulation has on larger competitors. For example, a regulation may be significant solely because the disparity in impact on small entities may make it more difficult for them to compete in a particular sector of the economy than large businesses. This may relate to their ability to pass costs through to customers or to reduce the marginal cost of those regulations to an insignificant element of their production functions.

One measure for determining economic impact is the percentage of revenue or percentage of profits affected. For example, if the cost of implementing a particular rule represents 3 percent of the profits in a particular sector of the economy and the profit margin in that industry is 2 percent of gross revenues (an economic structure that occurs in the food marketing industry, where profits are often less than 2 percent), the implementation of the proposal would drive many businesses out of business (all except the ones that beat a 3 percent profit margin). That would be a significant economic impact.

However, the economic impact does not have to seriously erase profits margins for an impact to be significant. For example, the implementation of a rule might reduce the ability of the firm to make future capital investment, thereby severely harming its competitive ability, particularly against larger firms. This scenario may occur in the telecommunications industry, where a regulatory regime that harms the ability of small companies to invest in needed capital will not put them out of the business immediately, but over time may make it impossible for them to compete against companies with significantly larger

capitalizations. The impact of that rule would then be significant for small telecommunications companies.

Other measures may be used; to illustrate, the impact could be significant if

a) the cost of the proposed regulation eliminates more than 10 percent of the businesses' profits;

b) the regulation exceeds 1 percent of the gross revenues of the entities in a particular sector or

c) the regulation exceeds 5 percent of the labor costs of the entities in the sector.

Some state agencies have already developed criteria for determining whether a particular economic impact is significant and whether the proposed action will affect a substantial number of small entities. Standards must be flexible enough to work for the individual agency.

The following examples, utilized at the federal level, are meant to be illustrative of different types of criteria that may be used. They are not meant to imply a standard, acceptable formula. The Council welcomes input from other agencies on their standards.

> *__The Department of Health and Human Services__ has determined that a rule is significant if it would reduce revenues or raise costs of any class of affected entities by more than 3 to 5 percent within 5 years. This approach may work well for an agency, depending upon the circumstances. It becomes complex, however, in the attempt to apply a simple rule fairly to varied industries and regulatory schemes. A 2 percent reduction in revenues in one industrial category would be significant if the industry's profits are only 3 percent of revenues. More than 60 percent of small businesses do not claim a profit and do not pay taxes; therefore, an agency would not be able to apply a profit-based criterion to these firms.
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> *The EPA has prepared extensive guidance for its rule writers concerning "significant economic impact" and "substantial number." With respect to small businesses, the agency advises that the offices compare the annualized costs as a percentage of sales ("sales test") to examine significant economic effect. For the same purpose, it also discusses alternative uses of a cash flow test and a profits test.

The absence of a particularized definition of either "significant" or "substantial" does not mean that Congress left the terms completely ambiguous or open to unreasonable interpretations. Thus, the Council would like to rely on federal legislative history for general guidance in defining these terms as submitted to the U.S. Office of Advocacy, located within the Small Business Administration.

Federal Legislative History of “Significant Economic Impact.”

With regard to the term “significant economic impact,” Congress said: The term “significant economic impact” is, of necessity, not an exact standard. Because of the diversity of both the community of small entities and of rules themselves, any more precise definition is virtually impossible and may be counterproductive. Any more specific definition would require preliminary work to determine whether the regulatory analysis must be prepared.

Congress also stated that,

> Agencies should not give a narrow reading to what constitutes a “significant economic impact”…a determination of significant economic effect is not limited to easily quantifiable costs.

Congress has identified several examples of “significant impact”:

- a rule that provides a strong disincentive to seek capital;
- 175 staff hours per year for record keeping;
- impacts greater than the $500 fine (in 1980 dollars) imposed for noncompliance;
- new capital requirements beyond the reach of the entity; and
- any impact less cost-efficient than another reasonable regulatory alternative.

None of these standards establishes a ceiling below which impacts are not significant. Other, more specific examples are contained in the House of Representatives Report on the Federal Regulatory Flexibility Act (RFA).

Legislative History of “Substantial Number.”

To affect a substantial number, a proposed regulation must certainly have an impact on at least one small entity. At the other end of the range, legislative history would not require agencies “to find that an overwhelming percentage [more than half] of small [entities] would be affected” before requiring a rule impact statement. Legislative history also says that the term “substantial” is intended to mean a substantial number of entities within a particular economic or other activity. The intent of the RFA, therefore, was not to require that agencies find that a larger number of the entire universe of small entities would be affected by a rule.

Quantification of “substantial” may be industry-or rule-specific. However, it is very important that agencies use the broadest category, “more than just a few,” when initially reviewing a regulation before making the decision to certify or do an initial regulatory flexibility analysis. The goal at this stage of the process is to ensure that the broadest possible impacts are fully considered.

The interpretation of the term "substantial number" is not likely to be 5 small firms in an industry with more than 1,000 small firms. On the other hand, it is important to recognize that 5 small firms in an industry with only 20 small firms would be a substantial number. Depending on the rule, the substantiality of the number of small businesses affected should be determined on an industry-specific basis and/or the number of small businesses overall. For example, the Internal Revenue Service, when changing the tax deposit rules, would examine the entire universe of small businesses to see how many would be affected. On the other hand, a change by FDA in the regulation of meat irradiators might affect only 15 firms, but that would be the entire industry.

Direct versus indirect impact

The courts have held that the RFA requires an agency to perform a regulatory flexibility analysis of small entity impacts only when a rule directly regulates them. \

The primary case on the issue of direct versus indirect impacts for RFA purposes *is Mid-Tex Electric Co-op, Inc. v. F.E.R.C. (Mid-Tex).* In *Mid-Tex*, The Federal Energy Regulatory Commission (FERC) was proposing regulations affecting how generating utilities included construction work in progress in their rates. Generating utilities were large businesses, but their customers included numerous small entities, such as electric cooperatives. FERC authorized large electric utilities to pass these costs through to their transmitting and retail utility customers. This increased cost to the transmitting utilities, which may or may not have been able (because of regulation by their rates commissions) to pass the costs on to their residential and business customers. These smaller utilities challenged the rule, asserting that the impact on them should have been considered. The court concluded that an agency may certify the rule pursuant to Section 605(b) when it determines that the rule will not have a direct impact on small entities.

The U.S. Court of Appeals for the District of Columbia applied the holding of the *Mid-Tex* case in *American Trucking Associations, Inc. v. EPA* (hereafter *ATA*). In the *ATA* case, EPA established a primary national ambient air quality standard (NAAQS) for ozone and particulate matter. The basis of the EPA's certification was that the NAAQS regulated small entities indirectly through state implementation plans. The court found that since the states, not EPA, had the direct authority to impose the burden on small entities, EPA's regulation did not have a direct impact on small entities.

The Office of Advocacy believes that it is good public policy for the agency to perform a regulatory flexibility analysis even when the impacts of its regulation are indirect. In the case of the NAAQS standard at issue in *ATA*, EPA had to estimate the impacts of the proposed rules on small entities in order to comply with the mandate of E.O.12866. Therefore, the agency could have examined alternatives that would have been less burdensome on small entities. If an agency can accomplish its statutory mission in a more cost-effective manner, the Office of Advocacy believes that it is good public policy to do so. The only way an agency can determine this is if it does not certify regulations that it knows will have a significant impact on small entities even if the small entities are regulated by a delegation of authority from the federal agency to some other governing body.

Adverse versus beneficial impact

Congress considered the term "significant" to be neutral with respect to whether the impact is beneficial or

harmful to small businesses. Therefore, agencies need to consider both beneficial and adverse impacts in an analysis. The RFA legislative history has explicit insights into congressional intent with respect to beneficial impacts:

> Agencies may undertake initiatives which would directly benefit such small entities. Thus, the term 'significant economic impact' is neutral with respect to whether such impact is beneficial or adverse. The statute is designed not only to avoid harm to small entities but also to promote the growth and well being of such entities.

Courts have applied definitions for "significant impact" in cases involving other statutes. For example, in a case involving the National Environmental Policy Act (NEPA), *Friends of Fiery Gizzard v. Farmers Home Administration*, the court held that a full environmental impact statement (EIS) does not need to be prepared if the only impact of the project will be beneficial. However, the court acknowledged that when both negative and beneficial effects are present, an EIS must be prepared even if the agency feels that the beneficial effects outweigh the negative ones. (This case does not say that beneficial impacts should not be considered for the preliminary assessment, nor does it say that beneficial impacts are never a factor.) Earlier cases interpreting NEPA held that beneficial impacts should be a consideration in the rulemaking process.